No. 80-1303

APR 7 198

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

THE POTOMAC EDISON COMPANY, *Appellant,*

v.

THE COMMONWEALTH OF PENNSYLVANIA, *Appellee.*

On Appeal From The Supreme Court Of Pennsylvania

APPELLANT'S BRIEF OPPOSING MOTION TO DISMISS OR AFFIRM

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ARGUMENT

The Equal Protection Argument, Which Is A Substantial Federal Question, Is Properly Before The Supreme Court Of The United States.

Appellant erroneously argues that, even if the Court finds that a substantial federal question is raised, the appeal should be dismissed because the federal question was not preserved properly. Appellant's argument is in-

apposite. *Great Northern Railway Co.* v. *Sunburst Oil & Refining Co.*, 287 U.S. 358, 363, 366-367 (1932); *Cumberland Coal Co.* v. *Board of Revision, Etc.*, 284 U.S. 23, 24-25 (1931).

The substantial federal question before this Court was raised in paragraph 4 of Appellant's application for reargument which was filed with the Supreme Court of Pennsylvania. In its application for reargument, Appellant contended, *inter alia*:

> "4. As a matter of law and fundamental fairness, Appellant is entitled to have its appeal adjudged by the same definition of the term 'manufacturing' as consistently applied by your Honorable Court to past tax litigants and as repeatedly accepted by the General Assembly in sessions, spanning more than 50 years. By failing to adjudge Appellant's claim according to its judicial definition of 'manufacturing', your Honorable Court failed to apply uniformly the manufacturing exemption from franchise tax in violation of Article IX, Section 1 of the Pennsylvania Constitution, and also deprived Appellant equal protection of law in violation of Section 1 of the Fourteenth Amendment to the United States Constitution. Affirming the Order of the Commonwealth Court imposes a greater franchise tax liability against Appellant than against other taxpayers whose franchise tax liability, and exemption therefrom under the manufacturing exemption, were previously adjudged by your Honorable Court under its judicial definition of 'manufacturing'."

Appellant was not able to raise this question until its application for reargument.

The federal question arose from the decision of the Supreme Court of Pennsylvania to adjudge Appellant's claim to the manufacturing exemption from Pennsylvania franchise tax by a different definition of the

term "manufacturing" than uniformly applied for over 50 years to all other taxpayers, foreign and domestic, which claimed the exemption from franchise tax and capital stock tax, since no basis exists for the difference and the Pennsylvania Supreme Court stated no reason for the difference.

Because the capital stock tax and franchise tax legislation contains no definition of the term "manufacturing", the Supreme Court of Pennsylvania judicially defined that term over 50 years ago. Without reason and without explanation, the Commonwealth Court of Pennsylvania departed from the judicial definition of the term. Jurisdictional Statement at 14-19. Because the Supreme Court of Pennsylvania, as the ultimate arbiter of Pennsylvania law, judicially pronounced the definition of the term "manufacturing", Appellant sought that Court's decision to correct the lower Court's improper departure from the judicial definition. The Supreme Court of Pennsylvania failed to do so, issuing only a *per curiam* Order affirming the decision of the Commonwealth Court of Pennsylvania, the lower court. Neither the Supreme Court of Pennsylvania nor the Commonwealth Court of Pennsylvania explained the departure from the definition in Appellant's case, although Appellee's persistent, improper remarks[1] about the admittedly adverse fiscal impact on the Commonwealth of Pennsylvania if Appellant receives the manufacturing exemption appear to have influenced the Pennsylvania Supreme Court's decision to affirm without issuing an opinion.

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[1] Appellant repeatedly objected and excepted to these remarks at trial and at oral argument. *E.g.*, Exceptions ¶ 12; Motion to Dismiss or Affirm at 24.

The Supreme Court of Pennsylvania failed to indicate whether the judicial definition of the term "manufacturing" was overruled or modified. The *per curiam* opinion of the Supreme Court of Pennsylvania presented Appellant with its first opportunity — by application for reargument — to raise the federal question involved in this appeal. Appellant did so in paragraph 4 of its application for reargument. The Supreme Court of Pennsylvania denied the application for reargument. If, as in the instant case, the decision of the state supreme court supplies a new basis for the defeated party's claiming the denial of a federal right, then the general rule cited by Appellee in its motion[2] is not applicable. *Great Northern Railway Co., supra.* Without any explanation, the Supreme Court of Pennsylvania failed to apply to Appellant's claim its own case law defining the term "manufacturing" for the purposes of the manufacturing exemption from franchise tax and capital stock tax. In so acting, the Supreme Court of Pennsylvania, itself, created, for the first time in this case, the federal question before this Court. Under similar circumstances, the *Great Northern* Court ruled:

> "The rule, general as it is, does not extend to cases where the constitutional question, however tardily raised, is considered and decided (*Consolidated Turnpike Co.* v. *Norfolk & O. V. Ry. Co.*, 228 U.S. 326, 334; *Cumberland Coal Co.* v. *Board*, 284 U.S. 23), nor does it apply where the grounds of the decision supply a new and unexpected basis for a claim by the defeated party of the denial of a federal right. *Brinkerhoff-Faris Trust & Savings Co.* v. *Hill*, 281 U.S. 673, 678; *Missouri ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U.S. 313, 320; *American Surety Co.* v. *Baldwin, supra.*

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[2] Appellee's Motion to Dismiss or Affirm at 17-19.

> This case is clearly with the second of these exceptions, if it is not also within the first. We have seen that the assault upon the judgment is made along two lines. The first is a challenge to the constitutional validity of the ruling in the *Doney* case, and involves a misconception of the decision in *Arizona Grocery Co.* v. *Atchison, T. & S. F. Ry. Co., supra.* The second is a *challenge to the constitutional validity of the ruling in this case whereby the statute is adjudged to mean one thing for some cases and another thing for others. This latter objection the petitioner could not make in advance of the event.* 287 U.S. at 367 (Emphasis added).

Moreover, as in the instant case, if the federal question is raised by application or petition for reargument to the state supreme court and the state supreme court rejects the federal question, then the general rule cited by Appellee also is inapplicable, regardless of when the federal question might have been raised in the state proceedings. *Great Northern Railway Co., supra; Cumberland Coal Co., supra.* In *Cumberland,* the taxpayer first raised the federal question by petition for reargument (now known as an application for reargument) filed with the Supreme Court of Pennsylvania. The petition for reargument was denied, rejecting the federal question. The taxpayer could have raised the federal question at any time in the state proceeding before filing its petition for reargument. Noting this exception to the general rule, the Supreme Court of the United States heard the case on the federal question, reversing the Pennsylvania Supreme Court. 284 U.S. at 24-30. This exception also applies at bar.

Appellant raised the federal question in its exceptions filed in the Commonwealth Court of Pennsylvania, by excepting to that Court's failure to apply to Appellant's claim the judicial definition of the term

"manufacturing" as applied to franchise and capital stock taxpayers in other Pennsylvania cases. Exceptions ¶¶ 3, 4, 5; Motion to Dismiss or Affirm at 21-22. Appellant sought to have the Pennsylvania Supreme Court correct this error, because that Court established the definition more than 50 years ago and thereafter applied the definition uniformly to all taxpayers claiming the manufacturing exemption, except Appellant. Instead, the Pennsylvania Supreme Court unexpectedly ignored the error without offering any reason for doing so.

Pennsylvania Courts Have Not Followed The Definition Which Was Used To Deny Appellant's Claim To The Manufacturing Exemption.

In denying Appellant's claim to the manufacturing exemption, the Commonwealth Court of Pennsylvania grafted to the judicial definition of the term "manufacturing" a requirement that "molecules of the original raw material survive in the final product". 411 A.2d at 1290, 1291: Jurisdictional Statement at 12a (Appendix C). Before and after the decision in Appellant's case, this requirement was not part of the judicial definition of the term "manufacturing". Jurisdiction Statement at 14-20, 23a-24a (Appendix F); *Kirks Milk Products, Inc.* v. *Commonwealth of Pennsylvania*, No. 1443 Commonwealth Docket 1976, before the Commonwealth Court of Pennsylvania (opinion filed April 3, 1981.[3] In *Kirks Milk*, the Commonwealth Court of Pennsylvania, without referring to its *Potomac Edison* opinion, held that a taxpayer's operations in producing skim milk powder and buttermilk powder by evaporation qualify for the manufacturing exemption. Although the *Kirks*

[3] The *Kirks Milk* Opinion is reproduced, in its entirety, *infra*, in Appendix A.

Milk Court noted that the judicial definition was derived more than 50 years ago, the Court made no reference to any supposed requirement that "molecules of the original raw material survive in the final product" in order to qualify for the manufacturing exemption under that definition.

The *Kirks Milk* opinion was issued on April 3, 1981. Research reveals that *Kirks Milk* is the only manufacturing exemption case decided by Pennsylvania courts after *Potomac Edison.*

CONCLUSION

For the foregoing reasons, Appellee's motion to dismiss or affirm must be denied; probable jurisdiction should be noted; and the order of the Supreme Court of Pennsylvania must be reversed.

Respectfully submitted,

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APPENDIX

IN THE COMMONWEALTH COURT
OF PENNSYLVANIA

No. 1443 C.D. 1976

KIRKS MILK PRODUCTS, INC., *Petitioner*

v.

COMMONWEALTH OF PENNSYLVANIA, *Respondent*

BEFORE: HONORABLE JAMES C. CRUMLISH, *President Judge*
HONORABLE ROY WILKINSON, JR. *Judge*
HONORABLE GLENN E. MENCER, *Judge*
HONORABLE THEODORE D. ROGERS, *Judge*
HONORABLE DAVID W. CRAIG, *Judge*
HONORABLE ROBERT W. WILLIAMS, JR., *Judge*
HONORABLE MADALINE PALLADINO, *Judge*

ARGUED: December 9, 1980

OPINION

Opinion by President Judge Crumlish Filed: April 3, 1981

Kirks Milk Products, Inc., appeals from a Board of Revenue and Finance determination that the production of skim milk powder and buttermilk powder does not constitute "manufacturing"[1] or "processing"[2] within the capital stock tax exemption. We reverse.

The stipulated facts follow: Kirks Milk Products, Inc. (Taxpayer) is a Pennsylvania corporation engaged in the storage, production, and wholesale-retail purchase and sale of milk, cream, butter, cheese and, for our purposes, buttermilk powder and skim milk powder. The taxpayer's total *powdered* dairy products output, approximately 91% powdered skim milk and 9% powdered buttermilk, is sold at wholesale and constitutes $566,008 and $54,041, respectively, of $1,763,880 in total gross receipts[3] for the tax period, November 1, 1973 through October 31, 1974.

Filing its Capital Stock Tax Report to reflect tax liability of $207.11, taxpayer asserted that buttermilk and skim milk powders were produced through "manufacturing," concluded that receipts therefrom were derived from the use of exempt assets, and reported its tax liability based only upon its non-manufacturing gross receipts or the raw milk purchased and resold at wholesale. However, the Department of Revenue settled the capital stock tax liability in the amount of $1,201.48 by denying exempt status for certain assets and adding in gross receipts for skim milk powder, buttermilk powder, and cream to taxable assets.

Since the sole question involved in this case is whether Taxpayer's production of buttermilk powder and skim milk powder constitutes "processing" or manufacturing" for purposes of exemption under Article VI of the Tax Reform Code of 1971, a discussion of the legal background will be followed by a detailed review of the production process.

Discussion

For nearly 100 years, the assets of Pennsylvania corporations engaged in manufacturing have enjoyed an exemption from capital stock taxation. *See Norris Brothers* v. *The Commonwealth*, 27 Pa. 494 (1856). More recently, our Supreme Court in *Commonwealth* v. *Deitch Co.*, 449 Pa. 88, 94, 295 A.2d 834, 838 (1972), expressed the purpose of the manufacturing exemption as created "to establish a favorable climate in Pennsylvania for manufacturers and thus encourage the development of industry. Additionally, there was a desire not to put domestic manufacturers at a competitive disadvantage with out of state industries[,]" who enjoyed tax exempt status in their adjoining home states. *And see Commonwealth* v. *Northern Electric Light and Power Co.*, 145 Pa. 105, 120, 22 A. 839, 841 (1891).

Since the tax laws fail to provide definitional guidelines, the judicial meaning and the corresponding practical interpretation of the term "manufacturing" becomes most impor-

tant. In *Armour and Co.* v. *Pittsburgh*, 363 Pa. 109, 116, 69 A.2d 405, 408-09 (1949), our Supreme Court summarized business activities which qualify for the exemption:

> It was said in *Commonwealth* v. *Weiland Packing Co.*, 292 Pa. 447, 450, 451, 141 A. 148, 149, that 'the process of manufacture brings about the production of some new article by the application of skill and labor to the original substance or material out of which such new product emerges. If however there is merely a superficial change in the original materials or substances and no substantial and well signalized transformation in form, qualities and adaptability in use, quite different from the originals, it cannot properly and with reason be held that a new article or object has emerged — a new production been created.' Nor is it of legal significance in this connection that the operations thus conducted require large and extensive plants and organizations, trained men and intricate machinery, for even though the labor be skilled, the operations delicate, a large plant involved, and expensive machinery utilized, such factors, neither individually nor collectively, covert what is essentially a mere processing operation into a manufacturing one: of, *Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 23, 66, A. 2d 295, 299.

Over the years, our courts have not only been consistent in narrowly defining the term "manufacture", but reluctant to grant the manufacturing exemption with respect to operations performed by taxpayers in the production of foods. Early on our Supreme Court held that the purchase, slaughter, cleaning, washing, sorting and resale of meat, hides, heads, and horns was not manufacturing within the capital stock tax exemption. *Commonwealth* v. *Consolidated Pressed Beef Co.*, 242 Pa. 163, 88 A.975 (1913). *See also Commonwealth* v. *Weiland Packing Co.*, 292 Pa. 447, 141 A. 148 (1928), where "manufacturing" status was denied pickled and dry salt pork, smoked hams and other pressed meat products.

A number of years later, the Supreme Court addressed the "manufacturing" status of milk products. In *Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 66 A.2d 295 (1949), the milk dealers' status as "manufacturers" under the mercantile tax exemption was questioned with respect to the production of pasteurized and homogenized milk and cream, butter, pasteurized cultured buttermilk, pasteurized skimmed milk, and our subject, skimmed milk powder. Classifying the milk dealers as manufacturers with respect to making ice cream, cottage cheese, and butter, our Supreme Court held that "[w]hile these articles are made from milk, they are 'a new and different article' from the milk originally purchased," but concluded that "[c]ondensed, evaporated and powdered milks are produced by boiling off, under controlled conditions, a portion of the water content of the milk; this is a variation of the process of reducing a raw material to its constituent parts for purposes of distribution." *Id.* at 22-23, 66 A.2d at 299.

However, certain methods of food production have fared well. In *Commonwealth*, v. *Snyder's Bakery*, 348 Pa. 308, 35 A.2d 260 (1944), the taxpayer's production of potato chips from raw whole potatoes, hot fat, vegetable oils, and salt constituted "manufacturing" for mercantile license tax purposes. The Court held that the manufacure of potato chips, consisting of storing raw potatoes at a given temperature for a specified period, testing, storing at increased temperature, cleaning, slicing, washing, drying, immersing in hot fat and vegetable oils, draining and drying, and salting and packaging, resulted in a product adapted to an entirely different use from the raw potato, the form and content of the finished product being entirely different.

In *Pillsbury Mills, Inc.* v. *Pittsburgh School District*, 408 Pa. 369, 372, 184 A.2d 236, 237 (1962), the milling of wheat into flour was held to be "manufacturing" for mecrcantile license tax purposes — "an intricate technologically sophisticated process. . . . The milling operation includes the

grinding, blending and processing of the many types of wheat into flour of varying characteristics which will be used for countless purposes."

Even in the case of *Commonwealth* v. *Berio Vending Co.*, 415 Pa. 101, 105-06, 202 A.2d 94, 96 (1964), where the production of popcorn was denied manufacturing status for franchise tax exemption purposes, the Supreme Court after discussion drew an important distinction:

> "[T]he production of popcorn, even though on an expanded scale, should not achieve the status of manufacturing as that term is popularly considered. The popping of corn does not require any sepcific skill or elaborate machinery. It can be done in the home by a child in a smaller scope in the same manner as appellant accomplishes in its plant. There is no application of labor, skill, art or science to provide a well signalized change as those terms are known. There can be little doubt that the courts have required a certain degree of skill, art or science be employed.
>
> * * *
>
> While the court below expressed doubt as to the current validity of the Snyder's Bakery case, we need express no view as to that observation. *It is quite clear that the production of popcorn involves far less control factors, skill and science* than does the production of potato chips." (footnote omitted) (emphasis added).

Consequently, we must examine the production methods used for both buttermilk and skim milk powders, and ascertain first, that a high degree of skill, science and labor has been applied to the liquid buttermilk and skim milk, and second, that a substantial transformation in form, qualities and adaptability in use has made the powdered milk a new, different and useful article.

Aside from arguing that the taxpayer's operation does not constitute "processing" within that added statutory exemption, the Commonwealth contends that the simple extrac-

tion of water has neither popularly nor judicially been regarded as manufacturing. *See Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District, supra* (milk products); *Commonwealth* v. *Glendora Products Co.*, 297 Pa. 305, 146 A.896 (1929) (roasting coffee), and *Commonwealth* v. *Babcock Lumber Co.*, 1 Pa. Commonwealth Ct. 45, 272 a.2d 522 (1971) (kiln drying pre-cut green lumber). While the production of powdered milk is clearly not "processing" within the exemption, we must disagree with the Commonwealth's "manufacturing" position.

In the *Rieck-McJunkin* case, our Supreme Court seems to have had no informed opportunity to examine evidence regarding either the taxpayer's machinery or production methods or the distinctive characteristics of the subject powdered milk. Although evidence was produced by the taxpayer, the chancellor made no findings of fact with respect to the taxpayer's production methods. In addition, the *Rieck-McJunkin* decision has lost much of its impact upon milk products in light of the recent processing exemption to the capital stock tax. As for *Glendora Products, supra,* and *Babcock Lumber, supra,* the manufacturing processbefore us goes far beyond roasting coffee and drying out lumber.

A. Skill, Science and Labor

Taxpayer utilizes an elaborate "Lo-Temp" evaporation system with a three-cycle process, identified by refrigeration, product, and spray drying stages, in the production of buttermilk and skim milk powders.

Operating on the evaoration principle, the initial "refrigeration" cycle removes water from the milk by using two vacuum chambers through which tubes carrying pressurized ammonia vapors act as a heating agent. These "first effect" and "second effect" chambers work hand in hand to create a condensed or concentrated, but still liquid, buttermilk or skim milk product. In the "first effect" chamber, since the milk is vacuum heated over the ammonia vapor tubes,

evaporation of the water content occurs at a relatively low temperature. The water vapor extracted from milk in the "first effect" chamber is then utilized as the heating agent in the "second effect" chamber, where the milk product is heated to a higher temperature under a vacuum and is concentrated or condensed still further as additional water is removed by evaporation.

In the second or "product" cycle of the Lo-Temp system, partially concentrated liquid buttermilk or skim milk products from the "second effect" chamber are pumped back into the "first effect" chamber. As the product flows down the tubes of the "first effect" chamber, its temperature is increased to between 165°F/73.9°C and 185°F/85°C, and additional water is removed by evaporation and pumped off by a condensate pump. Completion of this "product" cycle leaves a product which contains 42% to 48% milk solids by volume. Attendant are various physical and extremely complicated chemical changes in the liquid skim milk and liquid buttermilk as a result of the heating and concentration which took place during the "refrigeration" and "product" cycles. Serum proteins and cascine are denatured, the acidity of the product changes due to changes in chemical salt balances, the "heat stability" of the product is increased, and the product becomes increasingly viscous or "sticky."

The final stage of skim and buttermilk powder production is identified as the "Spray Drying" Cycle. The heated and concentrated product is forced at high pressure through an atomizing nozzle located at the top of a precipitating chamber. The atomized particles or droplets are exposed to a controlled air flow heated by a direct fired furnace, and upon reaching a temperature of 185°F/85°C, instantly release their remaining water content in the form of vapor. Dry buttermilk or skim milk particles, separate from but mixed with water vapor, pass into the primary collector where they are separated by "cyclonic" action. The powder is further cooled by air as it passes progressively through secondary and final production collectors and is finally sifted and placed in sealed containers.

Surely, that degree of skill, science and labor which "manufactured" potato chips in *Snyder's Bakery* and flour in *Pillsbury Mills* can be attributed to the elaborate Lo-Temp evaporation systems's three cycle production of buttermilk and skim milk powders.

B. New, different and useful product

Addressing the second prong of the "manufacturing" test, we conclude that resulting buttermilk and skim milk powders are new and useful product, substantially different in form, qualities and adaptability in use. In "form," the conversion from liquid to crystalline or solid is obvious. In terms of "qualities" and "adaptability in use," the record and stipulated facts speak for themselves. Aside from the "lactose" or crystalline reaction and the "browning" or chemical heat reactions, the resulting powders have almost indefinite "keeping" qualities, none of the coagulent, curding or enzyme properties, increased blending ability and greater flavor stability than do either buttermilk or skim milk. The principal commercial uses of buttermilk and skim milk powder are as ingredients in special dried foods and prepared dry mixes such as dry cake or biscuit mixes, dry soup mixes, prepared dry cereals, dry infant formulas and prepared dry dog and other animal foods, where it is not possible to use the liquid milks. Buttermilk and skim milk products are used extensively in the baking and confection industries as ingredients because of their unique ability to blend with sugar and cane syrups and flavorings at high processing temperatures without coagulating or resulting in undesirable flavor characteristics. Liquid milks have been found commercially infeasible because of such undesirable characteristics as flavor changes, inability to withstand the high cooking temperatures required coagulation or curding and the inability to produce a smooth viscous mixture of the candy product. Buttermilk and skim milk powders are also used extensively in virtually all areas of the prepared food industry in products such as canned or frozen soups, frozen dinners, frozen casseroles, meat sausages, canned meats, and canned gravies and sauces because of their

superior "keeping" characteristics, blending characteristics and flavor stability. In addition, aside from general use in the production of glue and adhesive materials, the powdered milks may be "reconstituted" and used as a beverage for human consumption with characteristics quite different from their liquid counterparts.

Having determined that taxpayer is entitled to the capital stock tax's manufacturing exemption for the fiscal year ending October 31, 1974, we reverse the decision and order of the Board of Finance and Revenue, and enter judgment in accordance with stipulation of Fact 41 in favor of the Commonwealth and against taxpayer in the amount of $207.11. The judgment shall be marked "satisfied" upon payment of docket costs by taxpayer and a credit of $994.37 shall be entered in favor of taxpayer on the proper books and records of the Department of Revenue.

Reversed.

Date: April 3, 1981 /s/ JAMES C. CRUMLISH
James C. Crumlish
President Judge

Judges Wilkinson, Jr., and Rogers dissent.

This decision was reached prior to the expiration of the term of Judge Wilkinson, Jr.

FOOTNOTES

[1] Section 602(a) of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 6, *as amended*, 72 P.S. §7602(a), provides in pertinent part:

> (a) That every domestic corporation . . . shall be subject to, and pay into the treasury of the Commonwealth annually, through the Department of Revenue, a tax at the rate of ten mills, upon each dollar of the actual value of its whole capital stock of all kinds . . . *provided, That the provisions of this section shall not apply to the taxation of the capital stock of corporations, limited partnerships and joint-stock associations organized for manufacturing, processing, research or development purposes,* which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the State . . . . (Emphasis added.)

[2] Section 602(c)(7), 72 P.S. §7602(c)(7), specifically provides a "processing" exemption to the capital stock tax:

> (c) The term processing, as used in this section, shall mean and be limited to the following activities when engaged in as a business enterprise:
>
> * * *
>
> (7) The production, processing and bottling of nonalcoholic beverages for wholesale distribution.

The exemption did much to alleviate the restrictive interpretation which had been placed upon "manufacturing" specifically relative to milk products. *See Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 66 A.2d 295 (1949).

Taxpayer's total gross receipts of $1,763,880 during the taxable period were derived from the sale of raw milk purchases and resold at wholesale ($315,892), cream ($123,698), butter ($175,161) and cheese ($529,080), buttermilk powder ($54,041) and skim milk powder ($566,008). [*sic*]

[4] [*sic*] For background purposes, we note that the exempt "processing" of separated and pasteurized liquid cream and skim milk occurs in two stages. In the initial stage of production, the "separation phase," raw whole milk is heated in large tanks, pumped into a continuous centrifuge, and separated into it constitutent parts — liquid skim milk and liquid cream. The second stage or "pasteurization phase" finds both the milk and cream heated under controlled conditions in a pasteurizer in order to retard the fermentation of milk sugars, prevent the formation of toxic substances, and generally destroy harmful bacteria.

The pasteurized cream is then utilized to produce butter and buttermilk through a third stage, an agitaiton or "churning process." Here, liquid cream containing 30% to 33% butter fat is placed in a low temperature mechanical churn and rotated until the "breaking point" is reached and butter "granules" are formed. Thin production of butter indisputably constitutes "manufacturing" within the scope of the capital stock tax exemption. However, the remaining liquid, a by-product of butter production, is drawn off and subsequently used in the production of buttermilk powder.

Taxpayer's entire production of liquid buttermilk and skim milk is then completely utilized in the production of buttermilk and skim milk powders.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1443 C.D. 1976

KIRKS MILK PRODUCTS, INC., *Petitioner*

v.

COMMONWEALTH OF PENNSYLVANIA, *Respondent*

ORDER

The Board of Finance and Revenue order, dated July 30, 1976, Board Docket No. R-1610, is hereby reversed, and judgment is directed to be entered in accordance with Stipulation of Fact 41 in favor of the Commonwealth and against Kirks Milk Products, Inc. in the amount of $207.11. The judgment shall be marked "satisfied" upon payment of docket costs by taxpayer and a credit of $994.37 shall be entered in favor of taxpayer on the proper books and records of the Department of Revenue unless exceptions are filed hereto within thirty [30] days.

Dated April 3, 1981 /s/ JAMES C. CRUMLISH,
James C. Crumlish,
President
Judge

FRANCIS C. BARBUSH
Cheif Clerk